

SEP 14 1993

FEDERAL COMMUNICATIONS COMMISSION  
OFFICE OF THE SECRETARYBefore the  
FEDERAL COMMUNICATIONS COMMISSION  
Washington, D.C.Implementation of Sections of  
the Cable Television Consumer Protection  
and Competition Act of 1992MM Docket No. 93-215

Rate Regulation

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September 14, 1993

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## SUMMARY

In its Reply Comments, Continental asserts that franchising authorities and the Consumer Federation of America have provided no evidentiary basis for the Commission to exclude intangibles from the cable television rate base. The Brockton, Massachusetts case study, previously submitted by Continental, demonstrates that the going concern value of a viable 10-year old cable system has been paid for by investors who incurred start-up losses and deferred returns. Thus, Continental believes that there is no basis for assuming that the intangible value of viable cable systems has been paid for by subscribers. Continental's previously submitted Fresno, California case study shows how acquisition prices in excess of the book value of tangible assets are not only required to compensate sellers for start-up losses and deferred returns, but are independently justified by unrealized economies of system clustering, improved marketing and customer service, channel upgrades and programming additions which increase penetration and public benefits. In Continental's view, there is no basis for excluding such arms length, negotiated prices which reflect real investments by sellers (reflected in start-up losses and deferred returns) and real economies to be gained by purchasers.

At this stage of industry development, cable is characterized by start-up losses, only 60% market penetration,

and a subscriber base, one-third of which must be replaced each year. Continental believes that there is no basis for applying to cable the utility rate base presumptions that have evolved over many decades for entrenched monopoly providers of universally penetrated, essential services. During a transitional phase, Continental urges the Commission to include start-up losses and deferred returns in the rate base of "built and held" systems, and to fully recognize acquisition costs for purchased systems.

The Commission should reject efforts by Local Exchange Carriers to handicap cable with an insufficient return. The LEC's assessment of long term risk for the cable industry is belied by objective evidence -- including cable's higher betas and debt costs -- documented in Continental's initial Comments. The LEC's claim for "regulatory parity" is a smokescreen for applying costly new rules to cable -- which the LECs themselves portray as outmoded -- without a means for cable to recover those costs. Their premise that "convergence" demands unity of regulation is ill founded. Continental points out that MCI and NYNEX are not regulated alike, merely because they both use fiber to transport voice and data. Continental argues that a minute area of overlap between businesses which do not share the same historical, workforce, financial, or technological characteristics, and which are at completely different stages of

development, should not dictate the imposition of Title II rules on cable. In Continental's view, nor is there any basis for applying a productivity offset or sharing obligation like that applied to Tier I LECs. There is no data for the cable industry comparable to that on which the LEC productivity offset was derived. Cable's ability to add channels does not lead to a proportionate increase in subscribers or revenues or decrease in costs, and therefore cannot be used as a productivity measure. The labor productivity evidence available shows a productivity factor of zero.

There should be no arbitrary restrictions on cost averaging and allocations by cable operators. The reality of Continental's various financial and operating structures (550 franchises, 143 headends and 65 operating units) and that of the cable industry as a whole necessitates allocations and some averaging. Cable operators must be permitted to assign costs appropriately, limited by the data available, GAAP records and FCC oversight.

Continental believes a reasonable mark-up should be permitted for programming costs and such costs should be expensed rather than included in the rate base. Additionally, taxes should be normalized and the rate of return adjusted for taxes. That treatment ensures that the expense will be recovered from the ratepayers who generate the revenue which will eventually be taxed.

The Commission should reject requests by franchising authorities to exclude entirely from the cable rate base those investments they feel are not beneficial to all subscribers. Such a formula would "balkanize" franchises and undermine niche programming.

Continental demonstrates that construction work in progress should be included in the rate base in order to promote rebuilds and avoid sharp rate spikes for consumers. Continental urges that both a recommended formula approach and a modified balance sheet approach support inclusion of cash working capital in the rate base. Cash working capital should not be held hostage to burdensome lead-lag studies as some franchising authorities advocate.

The Commission has deferred critical questions, including the basic fairness of regulated rates, and recovery of upgrade costs, to cost of service showings. In Continental's view, there is no basis, as some franchising authorities have urged, for now erecting artificial barriers to presenting cost of service showings. It is critically important for guidance of franchising authorities and the Commission's own staff for the Commission to facilitate the processing of such cases by setting forth the key principles now. Specifically:

o The Commission should establish that cable systems enter regulation with their intangible assets fully included in the rate base, and that the rate base of "built and held" systems be further adjusted for start-up losses and deferred returns.

o The FCC should establish the rate of return for cable television by using a modified risk premium approach and a 50/50 capital structure.

o Construction work in progress should be fully included in the rate base, along with other pro forma adjustments to an historic test year for known and measurable changes.

o Existing depreciation policies should be monitored, rather than represcribed.

o Cable systems should be permitted to employ an MSO's equipment and other costs averaged at higher accounting levels; and to allocate costs between basic and cable program service tiers without regard to artificial "tier neutrality."

o Streamlined cost of service cases should be permitted with adjustments to the benchmarks for addressability, and for exogeneous costs.

o Cable operators should be permitted to make future adjustments in rates established through cost of service proceedings by using GNPPI and externals.

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Rate Regulation )

REPLY COMMENTS OF CONTINENTAL CABLEVISION, INC.

INTRODUCTION

Continental Cablevision, Inc. hereby replies to the  
Comments filed August 25, 1993 in this Docket.

I. INTANGIBLES

Franchising authorities and the Consumer Federation of America ("CFA") generally oppose the inclusion of any intangibles in the rate base for cable television without proffering any sound reason for doing so. Each of the Comments which seeks to limit cable's rate base to tangible assets fails to offer any economic or financial evidence. They rest instead upon reflexive resort to utility principles which do not reflect economic and financial realities of the cable television industry. The premise for the usual presumptions against including intangibles, excess acquisition costs, and deferred returns in utility cases are clear: the assumptions are that ratepayers have already paid for the development of goodwill, which now reflects a public

good;<sup>1/</sup> and that during years of prior losses the utility has been assured the opportunity of making a fair return on invested capital.<sup>2/</sup>

The economic and financial case histories submitted by Continental clearly demonstrate that these assumptions are not applicable to the cable industry at its present stage of development. Whatever may be the case for utilities after decades of rate base regulation and universal penetration, the 10-year financial statements for Continental's Brockton, Massachusetts system demonstrate that past cable television subscribers have not paid for the development of today's cable business as a going concern.<sup>3/</sup> To the contrary, that development was paid for by long-term investors who incurred start-up losses and deferred returns while the business went through a characteristic growth cycle of adding subscribers gradually after substantial upfront capital investment. As the Commission recognized in the First Reconsideration Order (¶63), investors paid for that development and therefore are entitled to earn a reasonable return for the value of their investment over its

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<sup>1/</sup> Emery Troxel, Economics of Public Utilities, 327 (1947).

<sup>2/</sup> Galveston Elec. Co. v. City of Galveston, 258 U.S. 388, 395 (1921).

<sup>3/</sup> Comments of Continental Cablevision, Inc., MM Docket 93-215, August 25, 1993 ("Continental's August 25 Comments"), pp. 17-21 and Exhibit A.

entire life. Neither CFA nor any other Commentor has provided any factual evidence to substantiate the claim that cable subscribers (as opposed to investors) have paid to develop the going concern and other intangible values of cable systems. Thus, there is simply no basis for the Commission to apply inapplicable utility principles.

Continental's August 25 Comments also demonstrate that the usual presumptions against including acquisition premiums in long established regulated utility rate bases do not apply to cable television. From the seller's perspective, the sale price must recover not only the depreciated book value of the tangible assets, but also the start-up losses and deferred returns which have consumed investment capital. From the perspective of the purchaser, the acquisition price will also reflect the unrealized economies from which the purchaser and subscribers can derive future benefits. Continental's Fresno, California case history demonstrates how a near record purchase price was premised on Continental's ability and willingness to cluster systems, upgrade channel capacity, enhance marketing and improve customer service, and thereby increase penetration and revenues sufficiently to justify the acquisition price.<sup>4/</sup> Such documented improvements present unquestionable benefits to the subscribers. The

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<sup>4/</sup> See Continental's August 25 Comments at pp. 22-25 and Exhibit B to those Comments.

presumption against adding acquisition premiums to the rate base ought not to apply to cable, because cable acquisition prices are a function of market-driven, arms-length negotiated prices reflecting real investments by sellers (in start-up losses and deferred returns) and real economies to be achieved by purchasers for the benefit of subscribers.<sup>5/</sup>

Continental's factual submissions also belie the easy application of the second premise of conventional utility assumptions. Utilities today are regulated as long-entrenched monopoly providers of essential services. It is assumed that they have established and loyal customer bases, and therefore the opportunity to earn the prescribed return. By contrast, the cable industry has spent three decades building its subscriber base, is only a 60% penetrated service and must replace nearly a third of its subscribers each year.<sup>6/</sup> Losses and deferred returns accrued during the years of development were absolutely necessary to create viable systems. Had there been an opportunity to earn a current return during those years. Continental and other cable operators would have paid dividends to their investors. But even in a rate deregulated environment,

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<sup>5/</sup> See Comments of Continental Cablevision, Inc. pp. 46-50; Diane Sponseller, Goodwill: A Tangible or Intangible Rate-Making Component?, Public Utilities Fortnightly, 45 (Aug. 17, 1988).

<sup>6/</sup> Kagan, Marketing New Media, 1-3, Aug. 16, 1993.

cable operators did not pay dividends to investors. That is perhaps the strongest proof that prior years did not offer an opportunity to earn a current return, and the strongest basis for rejecting the inapplicable utility presumption against including past losses in the rate base.

Like the Massachusetts Cable Commission, the FCC should have "deep reservations" about disallowing start-up losses, deferred returns, and past acquisitions costs.<sup>7/</sup> If there is a presumption for cable rate regulation during this transitional phase, it should be that "built and held" systems should have a rate base adjusted to reflect the regulatory asset of those prior losses, and acquired systems should enter regulation in September 1993 with book intangibles fully included in the rate base.

Continental's economic evidence also belies the unsupported claims of franchising authorities that start-up losses and deferred returns cannot be calculated from financial records. Continental did just that for its Brockton case study, based solely on the system's books. This can likewise be done for other systems, making only such allocations from higher accounting levels as are used for all other parts of rate case cost accounting.<sup>8/</sup> There is simply no evidentiary basis in the

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<sup>7/</sup> Comments of the Massachusetts Community Antenna Television Commission, at 7.

<sup>8/</sup> See page 8 below and Continental's August 25 Comments at p. 73-77.

record of this proceeding to discard past losses, either for administrative convenience or for other reasons.

Nor is it sufficient to assume that investors' returns can be earned solely from selling cable systems. In its entire thirty-year history, Continental has never sold a system it has operated. It would be the most tortured perversion of public policy, and a complete contradiction of the intent underlying the Cable Act's anti-trafficking provisions,<sup>9/</sup> for the Commission to force long-term operators to sell their cable systems in order to earn a return. No other regulated industry is required to operate at a loss until companies sell-out, and few would invest in any industry required to operate at a loss.

Irrational demands to disallow all intangibles are perhaps best exemplified by CFA's Comments. Bereft of analysis, CFA resorts to the suggestion that intangibles should be allowed only if needed by a company to avoid bankruptcy -- that is, that all equity returns should be eliminated. As Chairman Quello has previously observed, this sort of extreme proposal "underscores that organization's pathological disregard for the real world implications of its suggestions."<sup>10/</sup>

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<sup>9/</sup> 47 U.S.C. § 537.

<sup>10/</sup> Order in MM Docket No. 92-266, FCC 93-372 (Separate Statement of Chairman Quello at 1) (Jul. 27, 1993).

## II. OTHER RATE BASE ISSUES

### A. Rate Base Exclusions

The City of Austin suggests that franchising authorities should have the right to exclude from the rate base those investments which they feel are of insufficient benefit to all subscribers.<sup>11/</sup>

Granting that untrammelled right to franchising authorities is entirely inconsistent with bedrock principles of the Cable Act and the cable industry. The Act seeks to promote choice among programming options, by way of anti-buy-through provisions, unbundling requirements, and a la carte incentives. The industry has developed over 70 video services, only a handful of which are mass-appeal foundation networks such as ESPN, CNN and USA. Most cable networks appeal to niche audiences as small as those who wish to watch golf full-time. If the investment needed to deliver such niche services is removed from the rate base, the economic basis for delivering these services will be undermined. Cable operators will either be incited to add all services to a more expensive basic tier, giving consumers no choice, or not to add them at all, defeating both choice and upgrade goals.

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<sup>11/</sup> Comments of Austin, Texas; King Co. Washington; and Montgomery Co., Md. at 3, 9.

B. Averaging and Allocations of Costs

Some of the Comments suggest that averaging of an MSO's costs be restricted a priori in various ways and that costs should be identified on a franchise-only basis. Continental submits that the accounting centers of various cable operators are much too diverse to establish in advance a universal standard for averaging. For example, Continental has 550 franchises, 145 headends, and 65 operations unit. Accounting records are generally not kept at the headend or franchise level, because management, customer service, and even converter repair transcend such lines. Balance sheet and income statements are kept at the company level (usually several operations units under a legal entity, such as Continental Cablevision of Broward County, Inc.). Property taxes, franchise fees, and other special assessments are assigned to specific franchises, but other costs require allocation and averaging.

It is the cable operator who maintains its books and determines the optimal management structure for its organization. It is the cable operator who uniquely possesses the knowledge necessary to formulate plans to consolidate and streamline management units. Clearly, the cable operator is in the best position to assign costs from higher accounting levels. Of course, the allocators which may be used are limited by the operator's own data, by comparisons the FCC will eventually make

after studying outputs, and by GAAP records which provide a suitable audit trail. Under these circumstances, the Commission should permit -- but not require, nor permit franchising authorities to require -- an MSO to use its own average costs and make allocations from accounting levels which make the most common sense in developing a cost of service showing for a particular system.

C. Construction Work in Progress ("CWIP")

Increasingly, rebuilds and upgrades span larger geographic areas encompassing several separate franchises. For example, Continental's recent Stockton, California system rebuild included three separate franchises serving approximately 54,000 subscribers and took 2 1/2 years to complete the 698 miles of new plant; a current Continental rebuild in southern New Hampshire encompasses 10 towns and 450 miles of plant and is projected to take three years. The Stockton rebuild required an investment of almost \$19 million, excluding capitalized interest. The New Hampshire rebuild will require close to \$10 million.

The upgraded or rebuilt system is often activated in parts of a franchise area over time. As a result, the system will have subscribers to the "old system" in part of the community paying "old" rates and subscribers in rebuilt portions of the community paying "new" rates. In the past, Continental planned its marketing campaigns for rebuilds so prices would

increase gradually as new product was offered. Incentives were also offered to encourage the purchase of higher levels of service and, importantly, to ease the transition from the old system and rates to the new. Although the new rate is usually associated for marketing purposes with additional programming, it is needed as well to cover construction costs.

As cable moves to a regulated environment it will be important to maintain incentives to upgrade systems and deal with changes in rate structures. If CWIP is not afforded the proper regulatory treatment, future investment in new technology will lag. If no return is permitted until an entire system is rebuilt and all subscribers switched from the old to the new, losses will accumulate and a disincentive to improve technology and service will have been mistakenly created. There is also the concern that prices will suddenly spike, leading to subscription downgrades or a loss of subscribers.

The Commission has recognized the validity of this historic form of rollout of new services in both its Freeze Order and its April benchmark Order. In the Freeze Clarification, the Commission granted permission for systems to continue to convert old subscribers to rebuilt rates as they were switched over to the new system.<sup>12/</sup> In the April benchmark Order, the Commission

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<sup>12/</sup> Order in MM Docket 92-266, FCC 93-185 at ¶ 8 n.6 (April 9, 1993).

granted permission to switch customers to the rebuilt system without contravening the negative option rule.<sup>13/</sup>

The following chart shows the progression of capital invested in the rebuild of Continental's Stockton system, capitalized interest and the addition of subscribers beginning, in this case, approximately six months after the rebuild began. Including CWIP in the rate base while construction progresses will avoid the severe problems suffered by electric utilities when CWIP was excluded and the utilities had to borrow to meet obligations to investors.<sup>14/</sup> Furthermore, cable operators no longer have the flexibility to absorb interest incurred during construction ("IDC"), which the Stockton illustration demonstrates to be substantial.

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<sup>13/</sup> Report & Order in MM Docket 92-266, FCC 93-177 at ¶ 442 (May 3, 1993) ("Report & Order").

<sup>14/</sup> Charles F. Philips, Jr., The Regulation of Public Utilities, 354-55 (1993).

**Continental Cablevision, Inc.**  
**Stockton, California Rebuild**  
**Analysis of Construction Work in Progress**

<u>Quarter Ended</u>	<u>Construction Costs</u>	<u>Capitalized Interest</u>	<u>Rebuilt Subs. Added</u>
Dec. '90	793,177 =====	0 =====	0 =====
Mar. '91	1,419,261	8,028	0
Jun. '91	1,363,368	20,834	0
Sep. '91	2,822,147	53,941	5,000
Dec. '91	<u>1,550,517</u>	<u>65,861</u>	<u>6,891</u>
	7,155,293 =====	148,664 =====	11,891 =====
Mar. '92	1,685,638	83,533	4,848
Jun. '92	1,950,307	91,605	6,993
Sep. '92	2,028,693	106,007	9,280
Dec. '92	<u>1,809,455</u>	<u>83,247</u>	<u>7,549</u>
	7,474,093 =====	364,392 =====	28,670 =====
Mar. '93	1,465,457	57,290	5,057
Jun. '93	1,566,307	23,892	5,480
Sep. '93	<u>498,541</u>	<u>142</u>	<u>2,255</u>
	3,530,305	81,324	12,792
	18,952,868 =====	594,380 =====	53,353 =====

Even if the Commission continues to permit the switch from old to new rates as the rebuild proceeds, it will nonetheless need to include CWIP in the rate base. Mechanically, the means for doing this requires an adjustment to the historical test year to add (1) construction work in progress during the years in which activation is scheduled, (2) known and measurable increases in that CWIP, (3) interest during construction (for investments preceding activation), and (4) capitalized marketing costs associated with the rebuild. Alternatively, adapting established utility rate case principles, the Commission could include CWIP, whether actually incurred or anticipated, in the rate base when the first group of subscribers benefits from the new system, i.e., when it becomes used and useful. At that point, the historical test year could be adjusted as described above. If that approach is followed, rates for customers on the rebuilt portion of the system will be properly priced (at post-rebuild rates), and customers will not incur frequent rate increases (through repeated cost of service cases) over the course of a multi-year rebuild. To the extent CWIP is not included in the rate base, cost of service filings will proliferate as the rate base changes during the several years of rebuild; capital management will become more problematical due to regulatory delays; and the rate base will need to be further adjusted by interest during construction.

D. Working Capital

The wide acceptance of the 1/8 formula submitted by Continental has resulted over the years because it was "determined to be a reasonable estimate of what a lead-lag study would produce without the related expense of a lead-lag study and the extensive hearing time used in reviewing these studies."<sup>15/</sup>

Some of the comments, such as those of Counsel to Municipal Franchising Authorities and the New Jersey BPU, suggest that because cable operators typically bill in advance for regulated services, cash working capital should be zero absent a lead-lag study. Continental submits that such a policy will effectively deprive an operator of cash working capital because of the cost of conducting a lead-lag study. Accounting professionals have also noted that "the use of detailed studies rewards the inefficient manager of cash and penalizes the more efficient. ... Such a result is contrary to enlightened regulated."<sup>16/</sup>

It might be possible to employ instead a modified version of the balance sheet method. Continental has sought to compensate for the flaws in many balance sheet methods by

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<sup>15/</sup> Robert L. Hahne and Gregory E. Aliff, Accounting for Public Utilities, §5.04[1] (1992).

<sup>16/</sup> Id. at § 5.04[7].

calculating cash working capital using cash, subscriber-only accounts receivable, and prepaid expenses as current assets and subscriber-only prepaid service income and converter deposits as current liabilities. A sample calculation is shown in the following analysis of cash working capital for several Continental systems. The analysis demonstrates that a modified balance sheet approach, using accounts comparable to those shown from Continental's general ledger, is available from existing records and should be an option for systems to employ, in lieu of a lead-lag study.

**Continental Cablevision, Inc.**  
**Working Capital Analysis**  
**For the Year Ending December 31, 1992**

<u>Account Description</u>	<u>St. John's County, FL</u>	<u>Will County, Ill.</u>	<u>St. Paul, MN</u>
Payroll Acct.	0	0	451
Collection Acct.	867,594	131,611	91,081
Refund Acct.	0	2,912	3,942
Petty Cash	0	600	392
Other Cash	0	567	0
Accts. Receivable- Subscriber	37,144	989,073	742,932
Prepaid Insurance	16,089	208,710	18,177
Prepaid Worker's Comp.	8,741	0	173,263
Prepaid Pole and Tower	5,652	7,321	17,145
Other Prepaids	7,317	4,817	132,121
Deposits	0	13,050	19,976
Prepaid Franchise Fee	0	0	0
Prepaid Service Income	-18,548	-95,595	-89,493
Converter Deposits	<u>-71,869</u>	<u>-212,251</u>	<u>-24,018</u>
Working Capital Per COS	852,121	1,050,814	1,085,970

### III. OPERATING EXPENSES

Continental believes that the most practical means for accounting for programming costs is to expense them on a current basis including a reasonable mark-up.<sup>17/</sup> Adding programming costs to the rate base would work only if the costs were amortized on a current basis.

A few Commentors suggest that taxes should not be normalized nor returns grossed up for taxes. The relative benefits of normalization versus flow through accounting have been debated thoroughly at the FCC, in Congress and by the D.C. Circuit. All have opted for normalization as the best means of assigning tax expense to the ratepayers who generate the revenue on which taxes will eventually be owed.<sup>18/</sup> If there is a tax benefit through deferral, it is accounted for by reducing the rate base for accumulated deferred taxes. If there is no tax benefit, there would be no such deduction.

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<sup>17/</sup> Continental will submit a specific means for recovering the expenses and return on new programming with its September 30, 1993 Comments.

<sup>18/</sup> Alabama Power Co. v. FCC, 773 F.2d 362, 371 (D.C. Cir. 1985).

#### IV. REGULATORY PARITY

Several local exchange carriers sound the refrain of "parity" with telephone regulation, particularly with respect to rate of return and productivity offset determinations. In fact, as Continental has detailed in its January 27, 1993 Comments in MM Docket 92-266, App. D, cable television uses different plant, has a different workforce, and utilizes different financing than does the telephone industry. Moreover, even the telephone companies acknowledge that cable has significant accumulated losses for which cable investors are entitled to compensating returns.<sup>19/</sup>

The telephone companies' comments seem intent on denying cable operators those returns in order to handicap their ability to attract capital and to compete in the market. For example, Bell Atlantic's affiant (VanderWeide) ignores cable's actual risk characteristics and conveniently confuses long-term and short-term circumstances in concocting his recommended return for cable. And, while he admits that cable companies are "closely held, widely diversified, and pay no dividends," he claims that firms which share none of these characteristics are nevertheless "comparable" to cable.

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<sup>19/</sup> See Joint Comments of Bell Atlantic, the NYNEX Telephone Cos., and the Pacific Telephone Cos. ("Bell Atlantic") at 27.